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## Miller, Brown and Other Lawmakers Voice Concern to Regulators About Bank of America's Move of Risky Derivatives to Taxpayer-Backed FDIC

Washington, D.C. – **U.S. Rep. Brad Miller (D-NC)** and **Sen. Sherrod Brown (D-OH)**, along with other members of the House and Senate, sent letters today to Treasury Secretary Timothy Geithner and to federal regulators on the Financial Stability Oversight Council (FSOC) expressing concern that Bank of America has moved trillions of dollars in derivatives from its subsidiary Merrill Lynch into a subsidiary insured by the Federal Deposit Insurance Corp (FDIC).

Three years after taxpayers rescued some of the biggest U.S. banks, lawmakers continue to question how to protect taxpayers from risks generated by investment-banking operations. The lawmakers are concerned with a reported increase in so-called 23A exemptions, referring to the section of the Federal Reserve Act that separates insured banking from investment activities.

In the letter sent today to regulators, lawmakers questioned the transfer of an undisclosed amount of derivatives from Merrill Lynch, a securities trading subsidiary, to Bank of America, a retail bank subsidiary. Bank of America's retail bank has $1.04 trillion in deposits, $548 billion of which are insured by the FDIC. The transfer reportedly happened following threats of further credit downgrades that would have forced Merrill Lynch to post an additional $3.3 billion in collateral.

"Regulators must stop treating transactions like this as a private matter," **Rep. Miller** said. "This kind of transaction raises many issues of obvious public concern. If the bank subsidiary failed, innocent taxpayers could end up paying off "exotic" derivatives."

"If banks are going to gamble, they should do it with their own money," **Sen. Brown** said. "Ending 'too big to fail' means that depositors and taxpayers are not asked to cover Wall Street's losses. It's time to put an end once and for all to taxpayer-funded bailouts of reckless banks."

Among the answers Miller and Brown and other Members seek include whether investigators determined if the transfer occurred to avoid the requirement to post additional collateral in light of the credit downgrade for the company. The lawmakers also want to know if the risk of the derivatives was determined and whether the newly-insured derivatives pose a risk to the financial system.

Three years ago, Bank of America received $45 billion in TARP funding to prevent its crash during the financial crisis.

The full text of the letters follow:

Members of the Financial Stability Oversight Council
c/o Secretary Geithner, Chairman FSOC
1500 Pennsylvania Avenue NW
Washington, DC 20220

October 27, 2011

Dear Secretary Geithner and Members of the FSOC,

We are writing concerning press reports last week that Bank of America Corp. (BAC) transferred an undisclosed amount of derivatives from Merrill Lynch, a securities trading subsidiary, to Bank of America NA, a retail bank subsidiary with $1.04 trillion in deposits, $548 billion of which are insured by the Federal Deposit Insurance Corporation (the FDIC).

Again according to the press reports, the transfer followed a credit downgrade of BAC and Merrill Lynch that might result in requirements by counterparties that Merrill Lynch post an additional $3.3 billion in collateral. The retail bank subsidiary has a higher credit rating and more in assets, and would thus be required to post less collateral. The counterparties reportedly requested the transfer to the retail bank subsidiary.

Bloomberg reported that the Federal Reserve favors the transfer to relieve BAC of the requirement of additional collateral, the FDIC opposes the transfer as increasing the risk to insured deposits, and BAC contends that regulatory approval is unnecessary.

The Bloomberg report was attributed to "people with direct knowledge of the situation." Regulators are apparently treating the transaction as a private matter, but the transaction raises issues of obvious public concern.

First, was the transfer reviewed under section 23A of the Federal Reserve Act, and if not, why not? The section limits transactions between non-bank and bank affiliates to protect the safety and soundness of banks and to avoid effectively subsidizing high-risk transactions with deposit insurance. Because of the favored treatment of derivative contracts in receivership, it appears highly likely that losses on derivatives would result in losses to insured deposits ultimately borne by taxpayers.

The transaction would avoid the reporting and review threshold of section 23A only if the transfer was of high-quality assets constituting less than ten percent of the retail bank's capital stock and retained earnings. The total capital stock and retained earnings of BAC and the retail bank subsidiary is $176 billion. The notional value of all derivatives held at BAC is $75 trillion, and as of second quarter of this year, $53 trillion of those were held in Bank of America NA. It is undoubtedly extremely difficult to translate the "notional value" of derivatives into actual risk, and we do not know how much of Merrill's derivatives portfolio was transferred to Bank of America NA. The reported demand by counterparties that Merrill Lynch transfer the derivatives to the retail bank to avoid a possible requirement to post additional collateral suggests that the derivatives pose substantial risk, however. Was the transfer treated as an asset purchase of the derivates by the retail bank from Merrill Lynch? If so, was the purchase price in what was obviously not an arm's-length transaction used to determine the applicability of section 23A?

Second, if regulators did review the transfer, either for purposes of approval under section 23A or to determine if such a review was required, how did regulators determine the risk posed by the derivatives? Did BAC or Merrill Lynch make their proprietary models available to regulators to assess that risk? Are any of the derivatives credit default swaps on European sovereign debt? If so, what effect would default on European sovereign debt have on potential liability under the swaps?

The derivatives are apparently complex, opaque, and not remotely standardized—at least one report called some of the derivatives "exotic." And according to another published report, even by the incautious standards of derivatives traders, Merrill Lynch was considered "the cowboy." And those calculations of risk assume that the counterparties will be able to pay any amount due on the derivative contracts, which AIG's counterparties learned three years ago to be a bad

assumption.

Third, if BAC completed the transaction without reporting under section 23A, what measures are available to regulators if regulators disagree with BAC's contention that reporting and review under section 23A was not required? Can regulators require rescission of the transfer? If the transfer of the derivatives to the retail bank would put insured deposits at risk, would the transfer of the derivatives back to Merrill Lynch create a systemic risk to the financial system?

Finally, if the transfer was not reported and reviewed under section 23A based on BAC's own assessment of the transfer, will regulators allow reporting and review under section 23A to be an honor system in the future?

We appreciate your prompt attention to this matter. If you have any questions, please contact Corey Frayer in Representative Brad Miller's office at (202) 225-3032 or corey.frayer@mail.house.gov.

Sincerely,

Rep. Brad Miller
Rep. Maxine Waters
Rep. Elijah E. Cummings
Rep. Michael E. Capuano
Rep. Stephen Lynch
Rep. Keith Ellison
Rep. Jan Schakowsky
Rep. Jackie Speier

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October 27, 2011

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve
20th and Constitution Avenue, N.W.
Washington, D.C. 20001

The Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Mr. John G. Walsh
Acting Comptroller of the Currency
Administrator of National Banks
Washington, D.C. 20219

Dear Chairman Bernanke, Acting Chairman Gruenberg, and Acting Comptroller Walsh:

Section 23A of the Federal Reserve Act restricts transactions between banks and their nonbank affiliates, placing limits on the amount of each transaction relative to a bank's capital and prohibiting purchases of certain "low-quality" assets.[1] The primary purposes of section 23A are protecting federally insured banks from riskier activities conducted by nonbank affiliates and preventing nonbank affiliates from benefitting from the subsidies provided by the federal safety net which undergirds insured deposits.[2] Congress sought to reinforce these principles in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), by restricting banks and their affiliates from engaging in proprietary trading or investing in private equity and hedge funds, while also requiring banks to move certain derivatives activities to their non-bank affiliates.[3] The Dodd-Frank Act also requires the Federal Deposit Insurance Corporation (FDIC) to acquiesce in any 23A exemption.[4]

In the depths of the financial crisis, Goldman Sachs and Morgan Stanley converted to bank holding companies, in large part so as to participate in Federal Reserve programs designed to support them, including the Federal Reserve's discount window. When the Board granted a 23A exemption to Goldman Sachs in 2009, Goldman moved its multi-purpose derivatives dealer into its insured bank affiliate. Likewise, Morgan Stanley converted to a bank holding company, and received an exemption for its derivatives business. And JPMorgan Chase Bank, N.A., currently holds 99 percent of the notional derivatives of JPMorgan Chase & Co.[5] These actions signal a troubling policy shift that has weakened limitations on insured banks engaging in risky activities and significantly expanded the federal safety net.[6]

We write today regarding recent reports that Bank of America Corporation, the nation's largest bank holding company by assets, has elected to transfer a substantial portion of its derivatives business from its broker-dealer affiliate Merrill Lynch & Company, Inc., to Bank of America, N.A. – the nation's second largest bank by deposits. As of June 30, 2011, the insured bank held $53 trillion in derivatives, an increase of $14.85 trillion – or 39 percent – from its holding prior to the

purchase of Merrill Lynch.[7] We are concerned because the reported transactions appear to violate the principles established in Section 23A of the Federal Reserve Act, and reinforced by Sections 619 and 716 of the Dodd-Frank Act, particularly "prevent[ing] the undue diversion of funds into speculative operations."[8]

At a time when systemically important banks are increasing their capital relative to their credit risk, these transfers are having the effect of increasing Bank of America, N.A.'s credit risk relative to capital. Section 11 of the Federal Deposit Insurance Act provides derivatives counterparties with the ability to terminate, liquidate, or accelerate their derivatives claims outside of the receivership process.[9] As a result of this provision, the FDIC Deposit Insurance Fund – and ultimately, the U.S. taxpayer – could be required to backstop the insured bank's derivatives losses in the event that the bank's capital cushion proves inadequate. These potentially risky, largely over-the-counter, transactions are now being directly backstopped by the FDIC's Deposit Insurance Fund – and ultimately the United States Treasury. This provides an additional safety net subsidy for one of the biggest derivatives dealers that is contrary to not only the principles, and potentially the strictures, of the Dodd-Frank Act, but also the original intent of the Federal Reserve Act and the Federal Deposit Insurance Act.

With respect to the recent actions by regulators to waive restrictions or otherwise permit the largest institutions to put depositors and taxpayers at risk for the banks' derivatives trading losses, we would like the regulators to answer the following questions:

- What policies are implicated by having a large derivatives trading operation within an insured depository institution?

- What was the policy basis for the decisions to allow large firms to put their derivatives trading operations in their insured depository institutions?

- What is your understanding of why institutions have asked to be able to have their insured depository institutions house their derivatives trading operations?

- What was the justification for allowing the transfer of derivatives trading operations, and what factors did you evaluate in making those decisions?

- What risks arise to the insured depository institution as a result of having the derivatives business principally operated out of it?

- Given the extremely large relative size of the derivatives trading operations of some banks, could losses in a derivatives trading operation threaten the solvency of their insured depository institutions?

- What efforts are being undertaken to ensure that, depositors, the Deposit Insurance Fund, and taxpayers are not put at any additional risk?

- Has the FDIC considered adjusting its risk-adjusted premiums to reflect any additional risk, and if not, why not?

Because taxpayers are now providing credit protection for Merrill Lynch's derivatives transactions, it is also important to know:

- What are the amount, composition, quality, counterparty identity, and credit exposure of the derivative contracts transferred from Merrill Lynch to Bank of America, N.A.?

- Is it your understanding that the reported transfers were requested by Merrill Lynch's counterparties?

- Do the reported transfers require Bank of America to obtain an exemption from Section 23A?

- Has Bank of America sought an exemption from Section 23A?

- If Bank of America has sought an exemption, what was the proffered rationale? Do you agree with this rationale?

- Have you granted, or do you expect to grant, Bank of America an exemption from Section 23A? If so, why?

- Have regulators accepted the living will submitted by Bank of America, pursuant to Section 165 of the Dodd-Frank Act?

If an exemption has been granted, please provide any relevant written records, including interagency communications, concerning the granting of the exemption.

Bank holding companies are intended to serve as a source of strength to their subsidiaries.[10] Unfortunately, as former FDIC Chairman Sheila Bair has noted, "[d]uring the crisis, FDIC-insured subsidiary banks became the source of strength both to the holding companies and holding company affiliates."[11] Congress, regulators, and other interested parties should take all necessary steps to ensure that these events do not repeat themselves.

We look forward to hearing your agencies' respective views on this issue. Given the sensitive nature of these developments, we would request your responses by November 11th, 2011. Thank you for your prompt attention to this important matter.

Sincerely,

Sherrod Brown
United States Senator

Carl Levin
United States Senator

Jeff Merkley
United States Senator

Mark Begich
United States Senator

Richard Blumenthal
United States Senator

Tom Harkin

United States Senator

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